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SENSITIVE
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EMBASSY TBILISI PLEASE PASS DEPUTY SECRETARY OF COMMERCE
SULLIVAN

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SUBJECT: SCENESETTER FOR DEPARTMENT OF COMMERCE DEPUTY
SECRETARY SULLIVAN VISIT TO BAKU, OCTOBER 29, 2008

1. (SBU) SUMMARY: Your visit to Baku comes on the heels of Azerbaijan's October 15 presidential election, which resulted in a landslide victory for President Ilham Aliyev. This fall also marked a troublesome time for the region, with Russia's invasion of Georgia casting a shadow on security and stability. Energy continues to figure prominently in Azerbaijan's geostrategic vision, economic development, and partnership with the United States. President Aliyev's next administration must address Azerbaijan's economic development and the need for additional political and economic reforms in the face of an international finance crisis, declining oil prices, and regional insecurity resulting from the Russia-Georgia conflict. Azerbaijan's leadership will be interested in hearing your views on the U.S. reaction to the international credit crunch ahead of the November 17 U.S.-Azerbaijan Economic Partnership Commission, which the State Department will host. Although Azerbaijan's overall macroeconomic situation is relatively stable, endemic rule-of-law and corruption problems, as well as monopolistic practices, continue to threaten sustainable growth in non-energy sectors. End summary.

MACROECONOMIC OVERVIEW

2. (SBU) Azerbaijan's economic performance in 2007 showed increasing resilience and strength as GDP grew last year by more than 25 percent, and is tracking to reach nearly 20 percent for 2008. Azerbaijan's continued growth prospects remain closely linked to oil prices, given that the energy sector provides 95 percent of total export earnings and more than 50 percent of GDP and an estimated 60 percent of budget revenue. In 2007, inflation reached 19 percent and in 2008 it looks likely to exceed 20 percent. Public investment is expanding rapidly, but more rigorous project selection and execution procedures must be put in place to ensure that these expenditures promote sustainable growth in the non-oil sector. In the coming year, the economy will continue to grow as Azerbaijan will receive a larger share of profits (80/20 split) from the ACG production sharing agreement. However, sharply lower oil prices and an international banking crisis will constrain that growth over the medium term. Given that the current budget is based on an assumed oil price of USD 70, Azerbaijan should be able to avoid deficits or funding shortfalls if crude oil prices remain at

or above current levels.

13. (SBU) The business climate outside the oil sector is challenging, but American companies have been able to report profits that are substantially higher than in developed markets. Corruption remains a serious roadblock to further investment. Transparency International's Corruption Perceptions Index (as well as anecdotal evidence from American business contacts in Baku) confirms that Azerbaijan still has a long way to go in stamping out corruption. On the other hand, Azerbaijan is taking important steps to simplify its regulatory requirements, and for this reason the World Bank named it the world's "Number One Reformer" in its most recent "Doing Business" report.

SECURITY

14. (SBU) As a result of the recent Russian invasion of Georgia, stability and security have become an area of uncertainty in the region. The Azerbaijani government, besides expressing concerns about threats to the East-West corridor for energy exports and other trade, has voiced its concern and desire to find a peaceful resolution in Norgorno-Karabakh (NK) and has called for more intensified international, and especially, U.S., attention to this "frozen" conflict. Press reporting has indicated that Russian President Dmitriy Medvedev has proposed a meeting between himself, President Aliyev and Armenian President Sargsian before the end of the year. The USG has also stepped up engagement. Deputy Assistant Secretary Matt

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Bryza, the U.S. representative to the Minsk Group, has been in the region multiple times since the Georgian invasion, actively working to assist in brokering a deal.

REFORM

15. (SBU) Securing and advancing U.S. interests in the longer term depends on Azerbaijan's continued stability and development. Although President Aliyev and his closest advisors continue to affirm their commitment to democratic reform, Azerbaijan's progress is incomplete. The media environment is heavily restrictive, with implausible criminal court cases against journalists and violent attacks against members of the media that have gone un-prosecuted and unpunished. Freedom of assembly, in practice, is severely limited. Opposition parties complain that the GOAJ has placed undue restrictions on their ability to organize and do basic grassroots work, and believe that they must have parity in electoral commissions in order to have a level playing field. As a result of these complaints, some opposition parties chose not to participate in Azerbaijan's October 15 presidential election.

16. (SBU) On the economic front, being named the number one reformer in the World Bank's "Doing Business 2009" report has boosted the spirits of many reform minded officials and called to task those ministries and agencies whose performance did not substantially contribute to that ranking. The WTO accession process could help bring about the legislative and regulatory changes needed to reform Azerbaijan's economy and introduce transparent, market-driven practices. President Aliyev pledged to support accelerating Azerbaijan's WTO accession in 2007 and, with the help of USAID's Trade and Investment Program, Azerbaijan has made significant progress towards accession. In this regard, the GOAJ developed and submitted to the WTO Working Group 30 draft legal and regulatory reforms designed to liberalize the trade and investment regime. Moreover, this past May the WTO held the first Working Party Meeting on Azerbaijan's WTO accession bid in almost three years, reflecting the GOAJ's renewed seriousness of intent in the area of trade reform. Recently, the GOAJ submitted comprehensive revised market

access offers, and as a result USTR has agreed to conduct a bilateral negotiating meeting on the margins of the next Economic Partnership Commission, scheduled for November 17 in Washington, and the WTO is planning a second Working Party Meeting tentatively in December.

STATE OIL FUND

17. (SBU) Since its creation in 1999, the State Oil Fund of Azerbaijan (SOFAZ) has acted as Azerbaijan's energy revenue stabilizer and long-term savings vehicle. The bulk of SOFAZ's inflows come from proceeds generated under production sharing agreements from sales of Azerbaijan's share of hydrocarbons; bonuses paid under the terms of production sharing agreements; acreage fees and other revenues. SOFAZ is one of the most transparent GOAJ organizations, publishing internationally-audited quarterly and annual reports. SOFAZ also plays a leading role in the Extractive Industries Transparency Initiative (EITI). In 2007, the United Nations awarded SOFAZ a public service award for its transparency, accountability and responsiveness in the public sector.

18. (SBU) SOFAZ currently has assets in excess of USD 10 billion (expected to grow to about USD 12 billion this year, and to generate about USD 200 billion in revenue over the next 15 years, based on an oil price of USD 70). In 2007, its rate of return was approximately five percent in real terms. Using a grant from the U.S. Trade and Development Agency, SOFAZ is now re-evaluating its portfolio strategy and developing a more aggressive investment strategy with the goal of boosting SOFAZ assets' rate of return. The management of SOFAZ assets appears sound. However, SOFAZ

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only incorporates 75 percent of oil and gas revenues above USD 50/barrel. The remainder is controlled by SOCAR and other elements of the government.
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